

# The two faces of the FCA's review of UK primary equity markets: "immediate technical enhancements" coupled with a potentially far-reaching consultation on market structure

On 14 February 2017, the Financial Conduct Authority (the "FCA") published a consultation paper "Enhancements to the Listing Regime" (CP17/4) (the "Consultation Paper") and a discussion paper "The UK Primary Markets Landscape" (DP17/2) (the "Discussion Paper") as part of its review of the effectiveness of the UK primary markets.

The Consultation Paper mostly proposes a technical simplification and codification of current market practice. However, the Discussion Paper foreshadows the possibility of far-reaching changes to market structures involving, among other things, a potential re-think of standard listings, a new segment for secondary listings by international issuers and the possibility of structural changes to encourage long-term capital.

## Background

As part of its 2016/2017 business plan, the FCA has carried out a review of the UK's primary markets and consulted with a number of stakeholders to assess how to improve the efficiency and effectiveness of the primary markets in order to meet the needs of issuers and investors.

Based on this review, and its interactions with advisers and issuers, in CP 17/4 the FCA is proposing a number of, primarily technical, amendments to the Listing Rules relating to the premium listing segment and associated technical guidance notes. In addition, in DP 17/2 the FCA sets out some higher-level discussions on the primary market landscape which are considered in the second part of this note.

## Part A - "Immediate technical enhancements" to the listing regime

Notable changes proposed in the Consultation Paper and discussed below include: (i) clarifications to premium listing eligibility requirements, including in relation to the requirement that an applicant demonstrate that it is carrying on an independent business and the requirements around an applicant's three-year financial track record; (ii) changes to the profits test used to classify transactions by premium listed issuers; (iii) a new concessionary route to premium listing for certain property companies; and (iv) the removal of the rebuttable presumption that a suspension of listing is required on a reverse takeover due to insufficient information in the market about the target.

## **Premium listing eligibility requirements: Listing Rule 6 simplified and market practice codified**

The FCA has concluded that the premium listing segment operates well and it is, therefore, not seeking to introduce any fundamental changes to the eligibility requirements for premium listing. The FCA is, however, proposing to simplify existing provisions to make them more accessible to market participants and better reflect market practice. The five key points to note are outlined below:

Firstly, the FCA is proposing to clarify the circumstances in which Listing Rule 6 (which contains premium listing eligibility requirements) applies. New drafting clarifies that, where an applicant for a premium listing is being inserted as the new holding company of an existing premium listed issuer (as part of a transaction which is not a reverse takeover), the requirements of Listing Rule 6 will not apply.

Secondly, it is proposed that the Listing Rules be amended to make explicit that any additional historical financial information that may be required under Listing Rule 6 (such as where there have been acquisitions during the three-year financial track record period) must be audited. A new technical note is also proposed to provide guidance on the calculations to be made in assessing whether additional financial information is required.

Thirdly, the FCA is proposing that the three-year financial track record requirement be amended to include an explicit requirement that the applicant must have been generating revenue for the past three years (this previously only appeared in the associated guidance).

Fourthly, the current overarching independence requirement (which is supplemented with a technical note illustrating circumstances in which it may not be met) is proposed to be replaced with three provisions requiring an applicant to demonstrate:

- that it carries out an independent business as its main activity;
- that it is able to carry out an independent business as its main activity despite having a controlling shareholder (if that is the case); and
- that it exercises operational control over the business it carries on as its main activity.

Each of these new provisions would be accompanied by guidance setting out factors which may indicate an applicant is not meeting the relevant requirement. It is also proposed that these provisions would be supplemented by a new

technical note which would give examples of situations in which *prima facie* further FCA enquiries may be required for it to satisfy itself that there is an independent business.

Finally, the FCA is proposing to remove the guidance in the Listing Rules stating that: (i) it may waive the requirement for inclusion of financial information and a financial track record; and (ii) it may dispense with the requirement for an applicant's group to have sufficient working capital available to meet its requirements for at least the next 12 months from the date of publication of the applicant's prospectus. The FCA considers it appropriate to remove this guidance to avoid misleading applicants as it does not normally waive the financial information and financial track record requirements and, specifically, has not waived the working capital requirement in the past and states it is unlikely to do so in the future.

### **CLIFFORD CHANCE VIEW:**

- The proposals are largely form over substance but do offer incremental improvements which would make Listing Rule 6 more user-friendly. This is particularly apparent in the revised independence requirements which would be set out in a more accessible format with three clearly delineated components each accompanied by their own guidance.
- Listing Rule 6 would more accurately reflect market practice (most notably, through the removal of the statement that the FCA may waive the working capital requirement).

## **Eligibility for premium listing: new concessionary route for certain property companies**

The Listing Rules already provide that companies in certain sectors, for example, mineral companies, may be exempt from certain eligibility requirements otherwise required to obtain a premium listing (for example, the three-year revenue earning track record). The FCA has concluded that the existing concessions remain appropriate and has proposed an additional concession applicable to certain property companies.

Two sub-categories of property companies that would be eligible for a new concessionary route from the revenue earning track record have been identified by the FCA:

- property companies established for less than three years which predominantly hold mature let assets which generate revenue (for example, a spin-out of a mature portfolio, for which the performance of the underlying assets rather than the current performance of the company will be of most interest to investors); and
- property companies that develop assets over the long-term and which have done so for at least three years through increases in the gross asset value of their real estate assets.

#### CLIFFORD CHANCE VIEW:

- This new concessionary route could make a listing on the Main Market more attractive for companies in the real estate sector (as opposed to AIM or overseas markets).
- Note only commercial companies would benefit from this concession, as investment entities are not subject to the three-year revenue earning track record requirement.
- The concessionary route would require the preparation of a property valuation report which is often perceived as a key element for investors in relation to these types of companies.

### Substantial transactions: changes to the profits test used to classify transactions by premium listed issuers

The FCA is proposing to modify the profits test (one of the four "class tests" used in the Listing Rules to determine the disclosure and approval requirements applicable to premium listed issuers undertaking substantial corporate transactions outside of the ordinary course of business, such as large acquisitions, disposals or joint ventures).

Where any of the percentage ratios arising from the class tests is 25% or more, the transaction is classified as Class 1 (which requires specific detailed disclosures to be made and approval of the transaction to be obtained from shareholders). The profits test is calculated by dividing the profits attributable to the assets the subject of the transaction by the profits of the issuer.

The FCA notes that it is frequently approached by issuers and/or their sponsors who believe that the class tests (including most notably the profits test) produce an anomalous result and do not accurately represent the true size of the transaction being entered into *vis-à-vis* the issuer.

Accordingly, the FCA is proposing to permit premium listed issuers, where the percentage ratio produced by the profits test is 25% or more, and such result is considered anomalous (having obtained guidance from a sponsor), to:

- disregard the profits test, provided all other class tests are below 5%. This would result in the transaction being unclassified for the purposes of the substantial transactions regime in the Listing Rules. This concession would not be available if such a transaction also qualified as a related party transaction under the Listing Rules; or
- make certain adjustments to the profits figures used as part of the profits test (in relation to costs incurred for an IPO or capital restructuring, or closure costs that are not part of an ongoing restructuring spanning more than one financial period). Any such adjustments would need to be applied consistently both to the issuer and its target (to ensure a like-for-like comparison).

Whilst issuers would still be required to obtain guidance from a sponsor in relation to the applicability of the class tests, there would be no requirement to consult or seek the agreement of the FCA for these purposes where the sponsor had concluded that the results of the profits test were anomalous.

The FCA is also consulting on whether further adjustments to the profits tests should be permitted and, in particular, whether alternative non-GAAP measures of profitability (such as EBIT and EBITDA) should be used for the purposes of the class tests (rather than PBT).

#### CLIFFORD CHANCE VIEW:

- The FCA's recognition that the profits test can produce anomalous results is welcome. This is an issue we have seen arise on a number of transactions.
- The proposals may facilitate shorter transaction timeframes by no longer requiring submissions to the UKLA in most cases of anomalous results from the profits test.
- The safeguards of a sponsor's involvement have been maintained.

#### CLIFFORD CHANCE VIEW:

- We view this as a pragmatic change which reflects market practice since the FCA has rarely suspended listings on reverse takeovers.
- The removal of the presumption could result in issuers more readily considering reverse takeovers.
- This change would mean the disclosure of inside information under the Market Abuse Regulation would need to be a key focus by a listed entity undertaking a reverse takeover (as it should be in any event).

### **Reverse takeovers: removal of the rebuttable presumption that suspension of listing is required due to insufficient information in the market about the target**

In relation to reverse takeovers, the FCA is proposing to remove the guidance requiring issuers (other than shell companies) to provide the FCA and the market with specified information in order to satisfy it that a suspension of the issuer's listing due to a lack of information in the market regarding the target is not required.

The FCA is proposing that this presumption of insufficient information no longer apply and, instead, it would assume that the market is able to operate smoothly on the basis of the information that the issuer already makes publically available as part of its existing disclosure obligations (such as the requirement to disclose inside information under the Market Abuse Regulation). This change would not apply to shell companies (for example, special purpose acquisition companies).

It should be noted that the FCA is not proposing to change its position that it may suspend the listing of an issuer in a reverse takeover if it considers that there is insufficient information in the market (including where it considers the issuer to be unable to accurately measure its financial position).

## **Part B - Assessing the UK primary equity markets landscape**

Through its Discussion Paper, the FCA is seeking to prompt a broad discussion about the effectiveness of the UK primary markets in providing access to capital for issuers and investment opportunities for investors (whilst recognising the distinct needs of both groups).

Notable themes raised in the Discussion Paper include: (i) whether the standard listing regime is fit for purpose; (ii) whether a new listing category should be introduced to facilitate dual-listings for international companies with an existing listing; (iii) whether exchange traded funds ("ETFs") should be required to list on the premium segment; and (iv) what structural changes could be made to better support the growth of science and technology companies in their "step-up" and pre-revenue phases.

The Discussion Paper also considers issues relating to the UK primary debt markets (such as whether there is place for a new wholesale bond multilateral trading facility in the UK, and whether measures should be taken to support wider retail access to debt markets), which are not discussed in this briefing note.

## The future of standard listings

The FCA highlights from its discussion with stakeholders, that unlike the premium listing segment, the standard listing segment is generally seen as unattractive due to a lack of clarity as to its purpose and the extent of the obligations imposed on issuers. The FCA is, therefore, seeking comments on the underlying rationale for the standard listing segment and whether the assumptions that supported its creation are still valid.

The FCA is also seeking views on whether a change of name might be warranted to avoid the perception, which may deter potential applicants, that "standard listing" is a second-best option.

### CLIFFORD CHANCE VIEW:

- The standard listing segment was introduced as an "EU directive minimum" regime to provide an alternative to the "super-equivalent" premium listing segment.
- In our experience, companies often consider a standard listing if they are unable to meet all of the "super-equivalent" eligibility requirements for a premium listing and intend for it to be a stepping stone towards a premium listing.
- If the standard listing segment were removed, would companies unable to meet the "super-equivalent" requirements for premium listing choose to list elsewhere in the EU?

## A new listing segment for international issuers?

Data analysis by the FCA has shown that the number of secondary listings by large overseas issuers (which already have a primary listing in their home jurisdiction) is declining. Few such issuers reportedly seek a standard listing of shares in situations where a premium listing might not be appropriate (for example, where the company has a dual-class voting structure), instead they largely favour a listing of global depositary receipts ("GDRs").

In light of GDRs being instruments targeted at sophisticated investors and which are not easily accessible to retail investors, the FCA has proposed a new listing segment offering overseas issuers the ability to observe high standards of corporate governance without having to meet all of the premium listing requirements (the FCA is also seeking views on which investor protections should apply to such a listing segment).

### CLIFFORD CHANCE VIEW:

- Liquidity and minimum free float requirements are likely to be key considerations.
- Dual share listings have declined in recent years, in part as investors have become more comfortable in investing directly on local exchanges.
- A new segment which offers liquidity but concessions from some of the "super-equivalent" premium listing requirements may prove attractive to large international mature companies seeking listings in multiple jurisdictions.

## Should the premium listing regime apply to ETFs?

The FCA has identified ETFs as an area where the investor protections stemming from the premium listing regime may be unnecessary and may not be valued by investors (as these vehicles are subject to regulations outside of the Listing Rules). Accordingly, the FCA is seeking input on whether ETFs should be taken outside of the premium listing regime.

### CLIFFORD CHANCE VIEW:

- The FCA took the decision in 2007/8 that investment entities would only be eligible for listing under the premium listing regime. Whilst the London Stock Exchange subsequently introduced the Specialist Funds Segment to provide an alternative for investment entities, providing more flexibility to attract ETF listings would be welcome.

## Better support for the growth of science and technology companies

The FCA discusses the challenges faced by science and technology companies from two perspectives: the provision of capital during their "scale-up" phase, and the pre-revenue phase where a "patient" approach to capital is required.

In relation to "scale-up" capital, the FCA notes that despite the diversity of UK primary equity markets focusing on growth companies (such as the High Growth Segment, AIM or the NEX Exchange Growth Market), there is evidence of the difficulties such growth companies encounter when seeking access to capital. Accordingly, the FCA is seeking input on whether enhancements to the primary market regulatory regime could address the problem. The FCA does, however, caution that a decision to allow such companies to access capital in public markets more easily needs to be assessed alongside the need to protect investors from risks.

In relation to "patient" capital, the Discussion Paper acknowledges concerns that the UK primary equity markets may not be effective in providing investment based on long-term considerations. The FCA is asking stakeholders to provide feedback on the relative importance to long-term investors and early-stage issuers of a number of features of the current capital markets model, as well as to the extent to which current market structures and regulations drive short-term behaviour. The FCA is also seeking input on which features a long-term capital market would need to have, and would need to avoid, in order to be effective.

### CLIFFORD CHANCE VIEW:

- This is perhaps the most open-ended element of the Discussion Paper. The focus on "exploring alternative market structures" to accommodate better long-term investors and early-stage issuers could presage significant new developments, especially in the context of the UK leaving the EU which opens up the possibility of radical changes to the regulatory environment.

## Next steps

The FCA has requested feedback and responses to the questions posed in the Consultation Paper and Discussion Paper by 14 May 2017. In the Consultation Paper, the FCA has announced its intention to publish amended rules in a policy statement in the second half of 2017.

In relation to the issues raised in the Discussion Paper, if the FCA decides to put forward any specific proposals, it will publish a consultation paper. The FCA has also recognised that the issues raised in the Discussion Paper have arisen in the context of the existing UK and EU regulatory framework and, accordingly, has stated that it will keep these proposals under review for any new developments stemming from the UK's negotiations to leave the EU.

The FCA has also confirmed that it will consult shortly on options for improving the availability of information in the initial public offering process following on from its publication of a discussion paper (DP16/3) in April 2016. For more background on this, see our note "[FCA opens debate on reform of the UK equity IPO process](#)".

If you would like to discuss any of the FCA's proposals and their potential impact for your organisation, then please contact any of the authors of this note.

A copy of the Consultation Paper is available at: <https://www.fca.org.uk/publication/consultation/cp17-04.pdf>

A copy of the Discussion Paper is available at: <https://www.fca.org.uk/publication/discussion/dp17-02.pdf>

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